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CHIEF INVESTMENT OFFICE

Capital Market Outlook

May 11, 2020

All data, projections and opinions are as of the date of this report and subject to change.

IN THIS ISSUE

- **Macro Strategy**—The deflationary shock from the government-imposed global economic shutdowns is the most powerful since the 1930s. Central banks were already falling further behind in hitting their inflation targets when the pandemic shock hit. Now they have an even bigger hole to climb out of. That means robust money supply growth is needed for several years. This abundant liquidity combined with aggressive government spending could help support risk assets and offers the potential for a strong economic recovery.
- **Global Market View**—The contours of the post-coronavirus investment landscape will be shaped by many factors, including the Four D's: debt, deglobalization, digitalization and demographics. Each of these dynamics will determine asset prices, risk premiums, earnings momentum, and the cost of capital, among other things, as well as macro metrics like real gross domestic product (GDP) growth, inflation, trade and employment.
- **Thought of the Week**—Headline risks related to coronavirus have driven municipal bond yields higher. We believe this provides an opportunity for investors, if they are selective with regards to credit.
- **Portfolio Considerations**—We favor equities relative to fixed income; prefer U.S. large caps relative to the rest of the world and are underweight all non-U.S. assets; and, in fixed income, we favor investment-grade bonds. Overall on a portfolio rebalancing basis—for those with an 18-month or longer time frame—we are buyers of equities on large weakness and suggest investors consider having dollar cost averaging plans ready as we head fully into the spring and summer months.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

Joseph P. Quinlan
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Head of CIO Market Strategy

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Vice President and
Market Strategy Analyst

THOUGHT OF THE WEEK

David Litvack
Managing Director;
Tax Exempt Strategist

Data as of 5/11/2020 and subject to change.

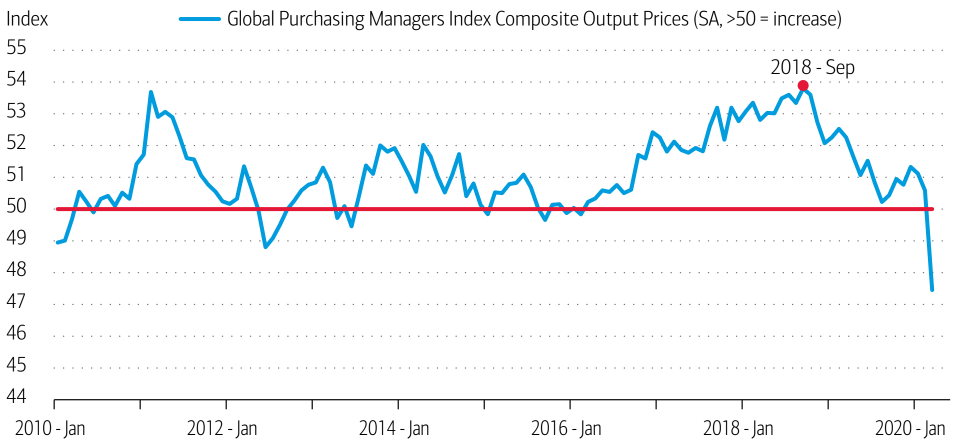
MACRO STRATEGY

Stopping Deflation

Chief Investment Office Macro Strategy Team

The lockdown of national economies has caused a major deflationary shock (Exhibit 1). This has started to show through in plunging oil and commodity prices. Broader price measures, like the "core" personal consumption expenditure (PCE) measure of consumer prices, went negative in March. Price measures were already weak before the pandemic hit as the Federal Reserve's (Fed's) aggressive tightening in 2017 and 2018 stopped inflation short of the target and caused it to decline from the middle of 2018. This was just the latest example of major central banks failing to provide sufficient accommodation to hit their inflation targets and help maintain a healthy nominal growth environment. Indeed, inflation has persistently fallen short of central-bank objectives for two decades.

Exhibit 1: Lockdowns Have Caused a Massive Global Deflationary Shock.



Sources: JPMorgan/IHS Markit/Haver Analytics. Data as of May 6, 2020.

In Europe and Japan, this has caused long-term inflation expectations to drop well below the 2% target that central banks have set, illustrating their lack of market credibility. The Fed has come closer to hitting its target, and long-term market-based inflation expectations were anchored closer to the 2% target, though still below. The deflationary shock from the pandemic changed that. Market-based inflation expectations have come unanchored, causing U.S. long-term interest rates to join those of Europe and Japan near zero. Basically, the market no longer believes that the Fed is going to hit its inflation target or even come close. This "Japanification" of U.S. inflation and interest rates is the inevitable result of two decades of policy failure to demonstrate that the Fed could achieve its only long-term objective.

After the policy mistakes of 2017–2018, the Fed began to acknowledge this failure to hit its inflation objective in a sustainable way. This prompted a reevaluation of monetary policy operating procedures that was kicked off in November 2018 and was slated to be completed by the middle of this year. The pandemic has pushed this major revamp to the backburner of recent Fed communications, as the focus has shifted to prevent another Great Depression.

Nevertheless, as shown in Exhibit 1, the pandemic has magnified the growing gap between the Fed's 2% inflation objective and the reality of deflation as reflected in collapsing inflation expectations. The impact of the pandemic makes it even more imperative that the Fed recapture some of its long-lost credibility on the inflation front. This is even more true for the European Central Bank (ECB) and the Bank of Japan (BOJ), as inflation expectations there were already well below supposed inflation targets.

By intensifying the disconnect between the Fed's stated objective and the rising deflation risk, the pandemic has upped the pressure on the Fed to get serious about raising inflation expectations back to target. The alternative is persistent deflation risk and the stagnant nominal growth environment that, for example, has plagued Japan for the past three decades.

Low inflation can always be increased by boosting the growth rate of the money supply. That's because *inflation is always and everywhere a monetary phenomenon.* Studies across countries and time periods have verified that major inflation periods were always accompanied by accelerations in money supply growth. That's why the worst hyperinflations are always associated with excessive money printing to pay for high government spending.

This last point has raised concerns about the ultimate inflationary consequences of the biggest U.S. fiscal deficits since World War II (WWII), when the U.S. routinely ran deficits of around 25% of GDP. Indeed, the fiscal and monetary situation today bears many similarities to that during WWII. During WWII, the Fed purchased massive amounts of government debt to cap interest rates at low levels across the yield curve. Money supply growth exploded with the deficits, as the Fed monetized large chunks of Treasury debt. This helped end the Great Depression and win the war. Despite some wartime price controls, inflation rose sharply. More recently, inflation worries arose during the first rounds of quantitative easing to address the 2008–2009 financial crisis. Those worries proved unfounded and may have caused the Fed to be too timid to hit its inflation target.

As the pandemic recedes, the situation will change. The key question for growth, inflation and interest rates is whether the Fed will aggressively continue to expand the money supply or will lapse back into the failed approach of the past. To get inflation sustainably up to target in a deflationary world, the Fed will likely need to monetize sufficient government debt to keep money supply growing at double-digit rates for a prolonged period.

Critics of this "monetarist" approach to controlling inflation have dominated academia, and therefore the Fed. They offer many reasons why it won't work, though none of the reasons stand up to serious scrutiny. Instead, the critics have relied on alternative theories of inflation that have failed one after the other to achieve the Fed's inflation objective. The most pervasive view has focused on unreliable tradeoffs between inflation and unemployment. That is why the Fed was surprised when the unemployment rate fell below 4%, and inflation failed to pick up sustainably. This flawed approach prompted the Fed to over-tighten in 2018 and slow the economy, causing disinflation pressures to increase (Exhibit 1) as money growth rapidly slowed.

Inflation is the measure of how money holds its overall value against goods and services. If the supply of money does not keep pace with the demand for money, the value of money will increase and the general deflation of prices will occur because of an insufficient supply of money. For example, high debt levels are associated with deflationary pressures because debts are repaid with money. If the money supply is not increased sufficiently to service debt, then deflation of prices occurs. Big debt-deflation cycles in the past were driven by rising demand for money without adequate money supply growth.

On the opposite side of the coin, the Fed couldn't understand why inflation was rising in the 1970s despite an ever increasing unemployment rate. This "stagflation" was the opposite of what the Phillips-Curve model predicted. Milton Friedman explained that it was explosive money supply growth that was causing inflation. Paul Volcker took his advice and explicitly slowed money supply growth in the early 1980s until inflation rolled over, and the rest is history.

All the excuses for why more money won't create inflation basically depend on the fact that money demand fluctuates endogenously with economic conditions, such as debt levels, incomes and risk aversion. These factors can increase the demand for money, meaning that it takes more money growth to achieve any given level of inflation. The key point is that increasing money growth sufficiently can always bring inflation up to the desired level. The pandemic caused a massive "dash for cash." The Fed has accommodated this sharp rise in liquidity preference. It needs to make sure that the money supply grows sufficiently in the future to move inflation expectations back close to the 2% target. Right now, in our opinion, the market does not believe it will.

Post the Pandemic: Debt, Deglobalization, Digitalization, Demographics

Joseph P. Quinlan, Managing Director and Head of CIO Market Strategy

Lauren J. Sanfilippo, Vice President and Market Strategy Analyst

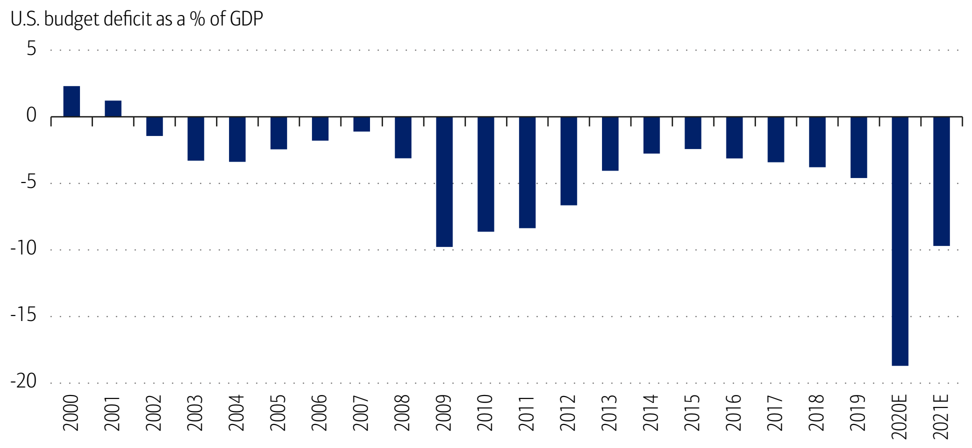
The contours of the post-coronavirus investment landscape will be shaped by many factors, including the Four D's: debt, deglobalization, digitalization and demographics. Each of these dynamics will determine asset prices, risk premiums, earnings momentum, and the cost of capital, among other things, as well as macro metrics like real GDP growth, inflation, trade and employment. In brief, we summarize below the four D's and pertinent investment implications.

More debt

Fighting coronavirus will prove to be very costly for governments around the world. Increased government spending, alongside collapsing output, means the average debt-to-GDP ratio in the developed nations will top 120% in 2021, according to estimates from the International Monetary Fund (IMF). France, Spain, the United States and the United Kingdom, among others, are all projected to have debt levels in excess of 100% of GDP by the end of the year.

Estimates from the U.S. Congressional Budget Office (CBO) are in line with the IMF's: The CBO expects U.S. federal debt held by the public to reach 101% of GDP by the end of fiscal year 2020 and widen to 108% by the end of 2021. That compares to 79% in 2019 and reflects the massive deficit spending precipitated by the pandemic and attendant plunge in growth. As Exhibit 2 illustrates, the U.S. federal budget deficit for fiscal year 2020 (roughly 18%) is set to explode and easily surpass the deficit levels of the Great Recession of 2008/09.

Exhibit 2: Deficit Projected to Top 18% of GDP in 2020.



E= Estimate. Sources: Committee for a Responsible Federal Budget; U.S. Treasury Department. Data as of April 2020.

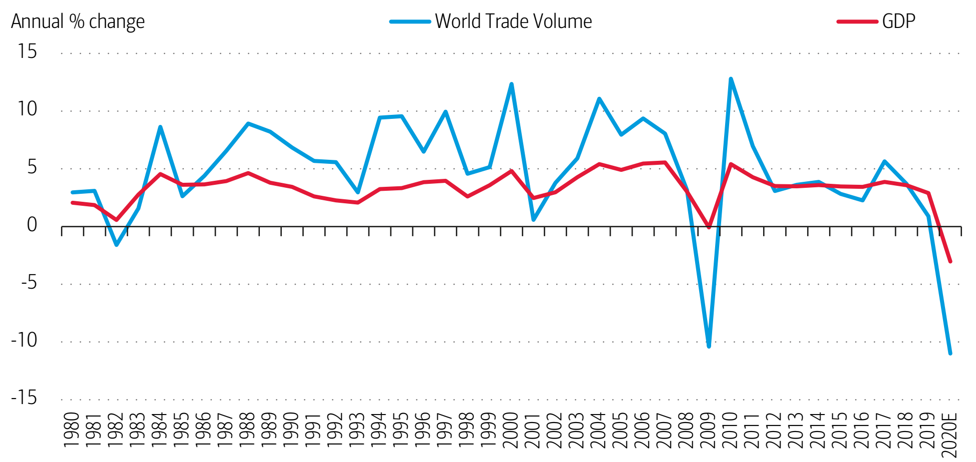
Now the good news: yes, there will be a massive debt overhang in the United States coming out of the crisis. But what matters more to asset prices is the cost of servicing debt, which in the U.S. is dirt cheap thanks to aggressive measures by the Federal Reserve and a ten-year bond with an interest rate of 0.7%. Any country that prints its own money has the wherewithal to keep interest rates low by buying bonds, as the Fed has been doing for over a decade. Continued Fed purchases and sustained foreign demand for U.S. securities portend low rates over the foreseeable future, and diminished risks around servicing U.S. debt levels. The combination of low rates and a rebound in growth will help debt levels stabilize and decline, as will a modest backup in inflation rates. The latter, in our opinion, is not a risk at this juncture.

For investors, this scenario favors equities over bonds, although when it comes to debt, it becomes more interesting and tricky at the state and local level. On that topic, see the "Thought of the Week" commentary to follow.

Faster Deglobalization

Even before the pandemic brutally shutdown global commerce, the global economy was fragmenting and turning inward owing to rising populist and nationalist movements in virtually every corner of the world, notably the U.S. and Europe. Owing in large part to U.S.-Sino trade tensions, global trade volumes barely grew in 2019 and are expected to plunge by over 10% this year, a steeper rate of decline than global GDP (Exhibit 3).

Exhibit 3: GDP and World Trade Growth.



E=estimate. Trade volume includes goods and services. Source: International Monetary Fund. Data as of April 2020.

All of this reflects a world becoming more fractured, with coronavirus only accelerating the pace of global disintegration. To wit, more than 75 nations in the past few months have restricted or banned exports of medical equipment and drugs. Medical protectionism has been paired with rising food nationalism, with many countries, realizing the importance of having a healthy and sustainable food industry, erecting barriers to trade in wheat, grain, rice and other food-related items.

Global supply chains are also being reconfigured—the model is shifting away from "just-in-time" to "just-in-case." The former was all about maximizing profits and minimizing costs, and pivoted on a China-centric global network of production. That's the past. The future: "just-in-case," whereby proximity matters (closer to home), redundancies are acceptable, and cost savings and profits take a back seat to security and adequate supplies. Across the industrial spectrum, U.S. multinationals are rethinking their global supply chain configurations, with added pressure from Washington to disentangle U.S.-China supply networks in such key sectors as technology and pharmaceuticals.

For portfolios, all of the above portends more spending and demand for robotics, artificial intelligence and 3D printing capabilities as more U.S. firms reshore their production platforms. The factory of the future, notably in high-end activities like semiconductors and pharmaceuticals, will be driven by machines, not humans, and be based closer to home as opposed to half-way around the world.

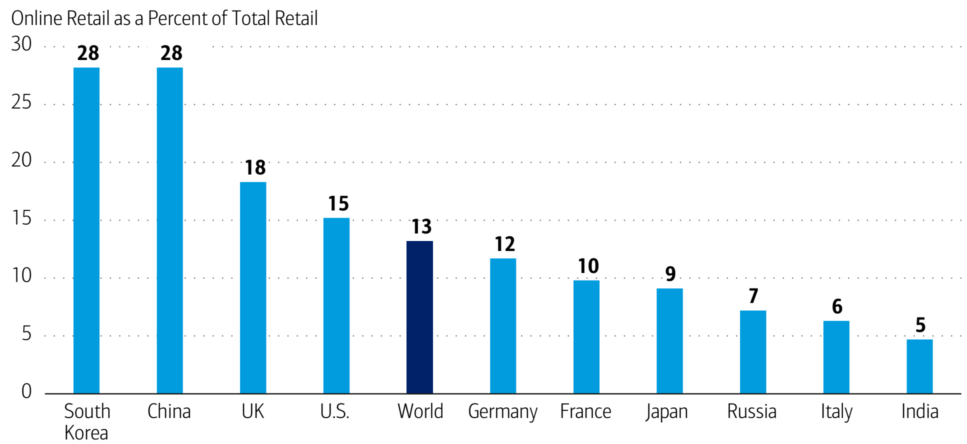
All things digital

If the pandemic is a catalyst for change in a post-coronavirus world, technology is the accelerant. As Microsoft CEO Satya Nadella was quoted, "*As COVID-19 impacts every aspect of our work and life, we have seen two years worth of digital transformation in two months*."[1] Many technologies and applications driving telemedicine, eCommerce, eLearning, eWallets and telework could encourage more permanent shifts to adoption curves after coronavirus. These changes could prove beneficial for the technology sector, transforming not only the way business, learning and working are done but also how consumers consume.

Used as a front-line response for pandemic control, various technologies showed promise in helping contain and manage the outbreak through artificial intelligence applications and mobile technology by aiding contact tracing and symptom checking. Add it all up, and coronavirus will leave a legacy of massive data collection in the medical, technology and social fields. Proper storage of this data will accelerate the transition to the cloud. An unprecedented $29 billion was spent on cloud infrastructure services by global companies in the first quarter of 2020, representing a year-on-year rise of 37%.[2] It's not only about collection but also control of this data relating to the exposure of bringing systems online and therefore creating more cyber vulnerabilities to be exploited and protected.

Commerce is more digitalized than ever before, especially for some pre-pandemic underpenetrated categories such as consumer staples and grocery. While the eCommerce adoption rate as a percent of total retail is around 15% in the U.S., coronavirus may influence more permanent online buying patterns to emerge across several retail channels lasting well onto "the other side" (Exhibit 4).

Exhibit 4: Stay at Home Orders Encourage Orders from Home.



Source: Euromonitor. Data as of 2019.

The technology sector's strong balance sheets, cash flow generation and dividend potential are also attractive facets in why we think the leadership of this sector is likely to continue. The future is digital.

Demographics as Destiny

In the post-coronavirus world, there will be a premium on human capital, notably a sharper focus on the demographic health of nations. If we have learned anything from the coronavirus pandemic, it's that health is a fundamental determinant to economic growth.

[1] Barron's "20.5 Million", May 11, 2020.

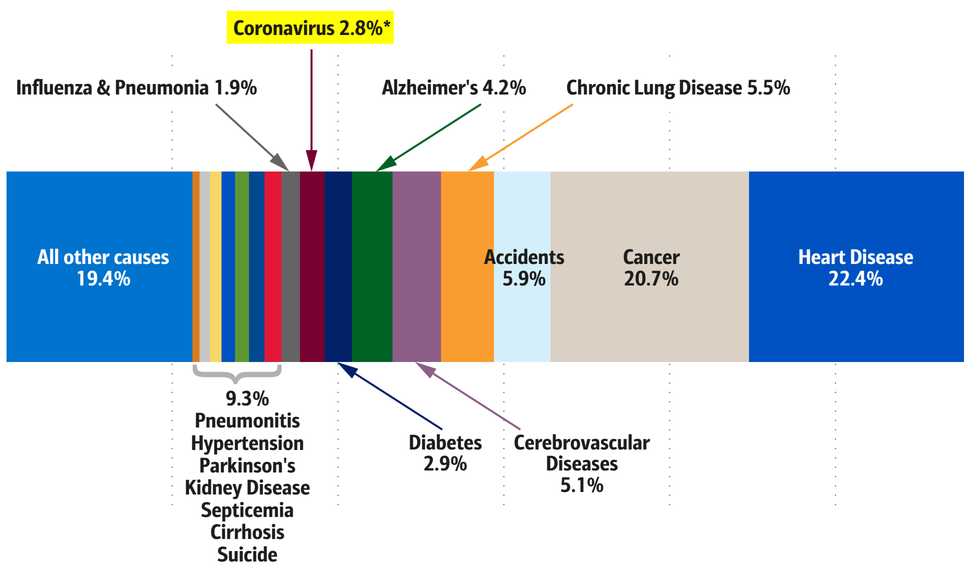
[2] According to Synergy Research Group, May 1, 2020.

This isn't new. Expanding life expectancies have been one of the principal drivers of global economic growth since the Industrial Revolution. The stronger and healthier the population, the stronger, more dynamic and competitive the economy. One key reason why "rich" nations are rich is because their populations (human capital) are robust and vibrant, backstopped by a healthcare infrastructure advanced in the battle against communicable and noncommunicable diseases, and adept at keeping workers and consumers healthy. In that health is an important form of human capital, there is a positive relationship between health and economic growth.

Enter coronavirus—which has not only pushed healthcare to the top of the agenda of every government in the world; it has also brutally exposed cracks in the healthcare systems of rich and poor nations alike, portending more global spending on healthcare in the decades ahead.

While it's true that global healthcare expenditures have climbed steadily over the past two decades, (nearly $8 trillion in 2017), healthcare as a percentage of world GDP has basically flatlined at around 9% to 10% over the past two decades. With the global proliferation of noncommunicable diseases, the global healthcare system was stressed before the pandemic—notably in the U.S. To this point, the U.S. has a higher mortality rate for "preexisting conditions," or noncommunicable diseases, than the global average, accounting for 88% of all deaths in the U.S. and two-thirds of all deaths globally according to the World Health Organization. Coronavirus will rank in the top 10 causes of deaths for this year, currently under diabetes mortality (Exhibit 5).

Exhibit 5: Noncommunicable Diseases are Leading Cause of Deaths in U.S.



*Coronavirus mortality data through May 11, 2020. Sources: CDC, World Bank. Data for latest available, 2018.

For portfolios, in the same way homeland security and defense spending rose in the U.S. post-9/11, so too overall healthcare spending is set to rise in the post-coronavirus world. This is a bullish prospect for world leaders in pharmaceuticals, diagnostic equipment, medical software/hardware, telemedicine and related medical goods and services.

THOUGHT OF THE WEEK

Higher Muni Yields May Provide Opportunities for Investors

David Litvack, Managing Director; Tax Exempt Strategist

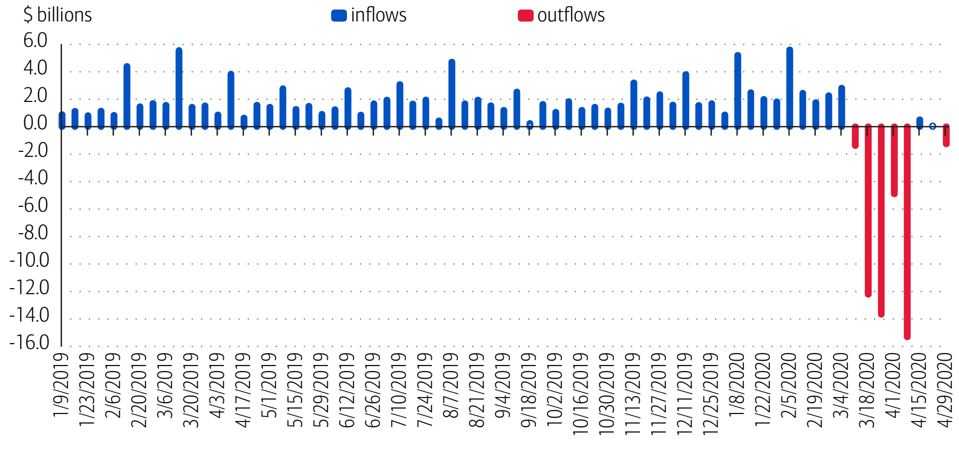
Headline risks related to coronavirus have driven municipal bond yields higher, which we believe provides an opportunity for investors if they are selective with regards to credit. Sales tax and income tax collections, the primary revenue sources of states, are down, along with revenues for municipal bond issuers in healthcare, education and travel. At the same time, depressed oil prices are affecting energy-producing states, and lower stock prices and bond yields are increasing funding gaps in public pension plans.

Given these trends, muni fund investors have been selling their holdings. After 60 consecutive weeks of inflows through February, muni funds saw five weeks of heavy outflows totaling $47.5 billion, causing those funds to sell bonds to meet the redemptions. The weaker demand also caused some municipal issuers to defer primary market bond sales. New issue muni activity in March ($18.6 billion) and April ($23.8 billion) were the lowest volumes for those months since 2011.

Because the buyer base for munis is relatively narrow, composed mostly of tax-sensitive, individual investors, the fund redemptions caused a backup in muni yields of about 200 basis points in mid-March. This market correction was likely further exacerbated by the dearth of price discovery in the primary market. While the muni market recovered somewhat in late March and early April, muni-to-Treasury yield ratios, typically about 70% to 95%, are still very elevated at about 200% or higher.

We believe currently elevated muni yields represent an opportunity. While credit risks are also elevated, support from Congress through the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") (over $300 billion), a future federal aid package to state and local governments that will likely total more than that, and the Fed's $500 billion Municipal Liquidity Facility, are expected to soften the blow. We favor general obligation bonds issued by state and local governments with structurally balanced budgets and strong balance sheets, as well as essential service revenue bonds (e.g., water/sewer and public power). We are cautious about issuers overly reliant on revenues from oil/natural gas, travel and tourism, capital gains taxes, and/or that have large unfunded pension liabilities. We are also wary of certain muni sectors such as senior living, private colleges, transportation/transit, and bonds backed by narrow revenue streams, such as hotel occupancy taxes or convention center revenues.

Exhibit 6: Municipal Bond Mutual Fund Flows.

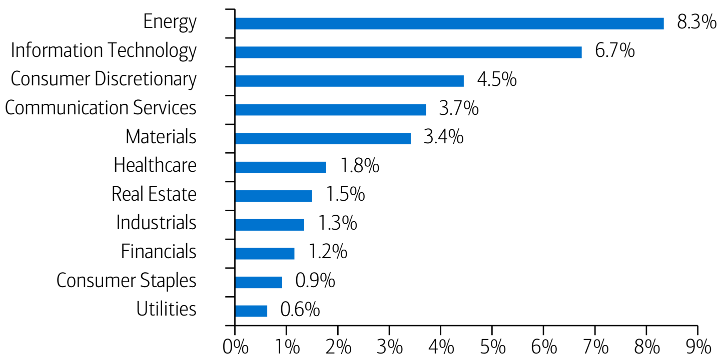


Source: Lipper. Data as of 5/1/2020.

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	24,331.32	2.7	0.0	-14.0
NASDAQ	9,121.32	6.0	2.7	2.0
S&P 500	2,929.80	3.6	0.7	-8.7
S&P 400 Mid Cap	1,676.18	5.4	1.8	-18.2
Russell 2000	1,329.64	5.5	1.5	-19.9
MSCI World	2,061.89	2.9	0.5	-12.0
MSCI EAFE	1,648.44	0.9	-0.5	-18.2
MSCI Emerging Markets	911.65	-0.5	-1.4	-17.8

S&P 500 Sector Returns



Fixed Income[1]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.46	-0.5	-0.7	4.9
Agencies	0.64	0.0	0.0	4.6
Municipals	2.02	0.8	1.1	-0.8
U.S. Investment Grade Credit	1.36	-0.3	-0.4	4.5
International	2.79	-1.0	-1.4	0.0
High Yield	7.88	0.8	0.6	-8.2

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.08	0.10	0.08	1.54
2 Year Yield	0.16	0.19	0.20	1.57
10 Year Yield	0.68	0.61	0.64	1.92
30 Year Yield	1.38	1.25	1.28	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	132.94	2.7	2.3	-22.7
WTI Crude $/Barrel[2]	24.74	25.1	31.3	-59.5
Gold Spot $/Ounce[2]	1,702.70	0.1	1.0	12.2

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.08	1.10	1.10	1.12
USD/JPY	106.65	106.91	107.18	108.61
USD/CNH	7.09	7.13	7.08	6.96

Source: Bloomberg, Factset.Total Returns from the period of 05/04/20 to 05/08/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 05/08/20 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 04/08/2020)

	Under-weight		Neutral		Over-weight
Global Equities				●	
U.S. Large Cap Growth				●	
U.S. Large Cap Value				●	
U.S. Small Cap Growth				●	
U.S. Small Cap Value			●		
International Developed		●			
Emerging Markets	●				
Global Fixed Income		●			
U.S. Governments		●			
U.S. Mortgages		●			
U.S. Corporates				●	
High Yield		●			
U.S. Investment Grade Tax Exempt			●		
U.S. High Yield Tax Exempt		●			
International Fixed Income	●				
Alternative Investments*	see CIO Asset Class Views				
Hedge Funds			●		
Private Equity					
Real Assets			●		
Cash					

* Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

Economic and Market Forecasts (as of 05/08/20)

	Q3 2019A	Q4 2019A	2019A	Q1 2020A	Q2 2020E	2020E
Real global GDP (% y/y annualized)	–	–	2.9	–	–	-3.1
Real U.S. GDP (% q/q annualized)	2.1	2.1	2.3	-4.8	-30.0	-5.6
CPI inflation (% y/y)	1.8	2.0	1.8	2.1	0.4	0.7
Core CPI inflation (% y/y)	2.3	2.3	2.2	2.2	1.7	1.7
Unemployment rate (%)	3.6	3.5	3.7	3.8	17.5	11.2
Fed funds rate, end period (%)	1.90	1.55	1.55	0.08	0.13	0.13
10-year Treasury, end period (%)	1.66	1.92	1.92	0.67	0.50	1.00
S&P 500 end period	2977	3231	3231	2585	–	2600
S&P earnings ($/share)	42	42	163	34*	25	115
Euro/U.S. dollar, end period	1.09	1.12	1.12	1.10	1.02	1.05
U.S. dollar/Japanese yen, end period	108	109	109	108	105	103
Oil ($/barrel, avg. of period, WTI**)	56	57	57	46	20	32

The forecasts in the table above are the base line view from BofA Global Research team. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts.

Past performance is no guarantee of future results. There can be no assurance that the forecasts will be achieved. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

A = Actual. E/* = Estimate. S&P 500 represents the year-end target for 2020. **West Texas Intermediate. Sources: BofA Global Research; GWIM ISC as of May 8, 2020.

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Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index.

Indexes are all based in dollars.

S&P 500 is a stock market index that tracks the stocks of 500 large-cap U.S. companies. It represents the stock market's performance by reporting the risks and returns of the biggest companies.

Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors.

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Investing involves risk, including the possible loss of principal.

Companies may reduce or eliminate dividend payments to shareholders. Historically, dividends make up a large percentage of stocks' total return.

Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

It is not possible to invest directly in an index.

Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets.

Keep in mind that dollar cost averaging cannot guarantee a profit or prevent a loss in declining markets. Since such an investment plan involves continual investment in securities regardless of fluctuating price levels, you should consider your willingness to continue purchasing during periods of high or low price levels.

Past performance is no guarantee of future results.

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